

**Improvements to the Questionable Form
W-4 Program Are Needed to Determine
Program Impact on Taxpayer Compliance**

October 2002

Reference Number: 2003-40-006

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

October 30, 2002

MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION

FROM: Pamela J. Gardiner
Acting Inspector General

SUBJECT: Final Audit Report – Improvements to the Questionable
Form W-4 Program Are Needed to Determine Program Impact
on Taxpayer Compliance (Audit # 200240013)

This report presents the results of our review to determine whether the Internal Revenue Service's (IRS) Questionable Form W-4 (QW-4) Program productively identifies instances of taxpayers inappropriately claiming either excessive withholding allowances or exemption from withholding on their Employee's Withholding Allowance Certificate, Form W-4.

We conducted this review as a part of the Treasury Inspector General for Tax Administration's Fiscal Year 2002 discretionary audit coverage concerning revenue protection in the Wage and Investment (W&I) Division. Properly claiming the correct withholding allowance ensures that taxpayers are meeting their obligation for income tax withholding from wages and other forms of income.

In summary, although the QW-4 Program's current measures are insufficient to determine the effectiveness of the Program, management is working toward improvements. One improvement, in the form of a computer-programming enhancement, should enable staff hours to be used more productively. However, the QW-4 Program currently has no established outcome measures¹ that effectively identify productivity and its contribution to the IRS' goal of improving compliance. Management cannot determine whether employers are complying with directives to change the amount of tax withholding and QW-4 management information reports do not aid management in identifying the most productive cases.

¹ Outcome measures are the assessment of the results of a program activity compared to its intended purpose.

Management's Response: IRS management responded favorably and agreed with the information included in our report. Specifically, they stated that our report accurately identified the need for changes in the QW-4 process. Management will redesign the screening process and develop new inventory sources through database matching.

Management's complete response to the draft report is included as Appendix V.

Copies of this report are also being sent to the IRS managers who are affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Michael R. Phillips, Assistant Inspector General for Audit (Wage and Investment Income Programs), at (202) 927-0597.

**Improvements to the Questionable Form W-4 Program Are Needed
to Determine Program Impact on Taxpayer Compliance**

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Improvements to the Questionable Form W-4 Program Are Needed to Determine Program Impact on Taxpayer Compliance

Background

Federal income tax is collected on a pay-as-you-go basis. Taxpayers must pay the tax as they earn or receive income during the year. The Internal Revenue Service (IRS) collected \$1.1 trillion from individual taxpayers during Fiscal Year (FY) 2000. During this same year, income taxes paid by individual taxpayers accounted for over half of all taxes collected by the IRS, and the majority (69 percent) of the individual income taxes were collected through employee withholding.¹

Internal Revenue Code (I.R.C.) § 3402 provides the legal authority for income tax withholding from wages and other forms of income.² It specifies the general form and content of the Employee's Withholding Allowance Certificate (Form W-4) and outlines the basis for claiming withholding allowances or exemption from withholding. Properly claiming the correct withholding allowance ensures that taxpayers are meeting their obligation for income tax withholding from wages and other forms of income. I.R.C. § 3403 provides that the employer is liable for tax imposed under law and the related tax regulations and is liable for the appropriate amount of withholding whether or not it is actually deducted from the employee's (taxpayer's) pay.³ IRS forms and publications provide these requirements and instructions on how to complete the forms.

The IRS reported that \$4.6 billion due (owed by taxpayers) in Tax Year 1998 was a result of under withholding, partly due to questionable Forms W-4. The IRS defines a questionable Form W-4 as any Form W-4 where the taxpayer is claiming more than 10 withholding allowances or any Form W-4 where the taxpayer's wages are over \$200 per week and the taxpayer is claiming exemption⁴ from withholding. Each withholding allowance reduces the

¹ Withholding is the amount of tax an employer withholds from an employee's income and pays to the IRS in the employee's name.

² I.R.C. § 3402(a)(1) (2001).

³ I.R.C. § 3403 (2001).

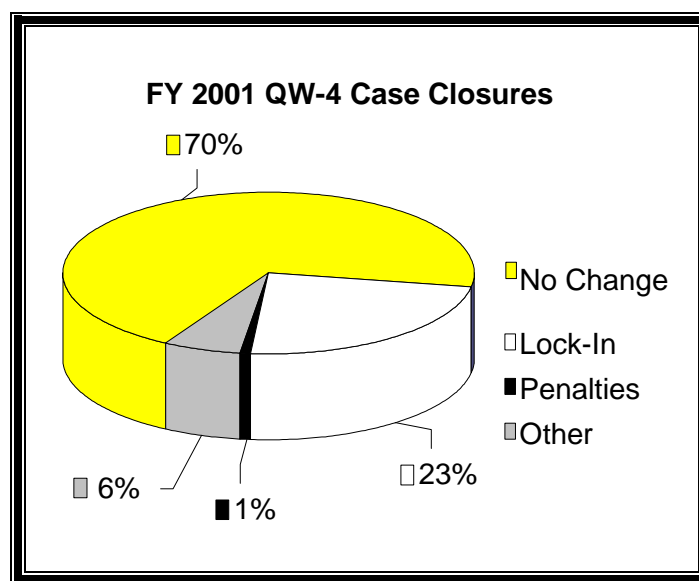
⁴ Employees can claim exemption from withholding if they had a right to a refund of all federal income tax withheld for the prior year and expect a refund of all federal income tax withheld in the current year.

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amount of federal income tax withheld from the taxpayer's wages; the amount of withholding depends on the taxpayers' wages and allowances and can range from zero to hundreds of dollars. Form W-4 has worksheets to help taxpayers calculate how many withholding allowances they should claim. The worksheets are for the taxpayers' own records.

The Questionable Form W-4 (QW-4) Program is part of the Wage and Investment (W&I) Division, and its mission is to promote compliance with the tax and withholding system by taxpayers who reduce or eliminate tax withheld from their wages by filing an incorrect Form W-4. To accomplish this mission, the IRS requires employers who receive questionable Forms W-4 from taxpayers to submit these forms for review. The IRS' QW-4 Program employees (tax examiners) examine the forms and, where appropriate, the tax examiners require employers to increase taxpayers' tax withholding. The IRS can also assess civil penalties against taxpayers. See Appendix IV for details on how the IRS processes questionable Forms W-4.

During FY 2001, the QW-4 Program received approximately 63,800 cases for tax examiners to work. Tax examiners closed 60,226 cases.



Source: FY 2001 QW-4 Case Disposition Report

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Approximately 42,000 of the 60,226 cases were initially screened and closed with no change to the number of exemptions allowed. Approximately 14,100 cases were closed with adjustments to the number of exemptions claimed (referred to as lock-in); 600 were closed with penalties; and 3,600 were classified as “other.”⁵

The QW-4 Program has undergone several reorganizations since the early 1980’s. It has moved from a manual process with employees throughout the IRS to a more automated process with 27 employees centralized in 1 office. With the IRS’ reorganization in FY 2001, the Program centralized to the Fresno Compliance Campus (FCC).

We performed the audit in the FCC, the Detroit Computing Center (DCC), Martinsburg Computing Center (MCC), and the W&I’s Headquarters Office between October 2001 and July 2002. The audit was conducted in accordance with *Government Auditing Standards*. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

Current Program Measures Are Insufficient to Determine the Effectiveness of the Program

The QW-4 Program is not effectively identifying instances when employers and taxpayers do not comply with its directives to change withholding allowances claimed on Forms W-4. In addition, its management information reports do not identify the most productive cases. This occurs because the QW-4 Program currently has no established outcome measures⁶ that effectively identify productivity and its contribution to the IRS’ goals of improving compliance.

⁵ The total for the 4 closed case categories on the chart is about 3,000 cases less than the total closed cases on the disposition report. Management does not have an explanation for the difference. They explained that the report is a snapshot of a moving inventory; the volume of closed cases might not equal the volume of the four closure types listed on the report.

⁶ Outcome measures are the assessment of the results of a program activity compared to its intended purpose.

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Specifically:

- The QW-4 Program does not accumulate information on compliance with the Letter 2800, Lock-In (Employer).⁷
- Management reports do not identify the most productive cases.

Sound management practices require the IRS to set performance goals for organizational units and to measure the results achieved by those organizations with respect to those goals. Without appropriate performance measures and indicators, the IRS is not able to determine the impact its QW-4 Program is having on compliance.

IRS management has conducted studies of this Program. A 1998 compliance impact study found that, when implemented, Letter 2800 is an effective tool in increasing withholding and moving taxpayers from a balance due position to a fully paid or overpaid position at the time of filing.⁸ In addition, in December 2000, the IRS conducted a redesign study of the QW-4 Program.⁹ The study found that the IRS is only able to work 10 percent of the questionable Forms W-4 received. The study also identified several limitations of the current process. One recommendation of the study was for a trial implementation of the redesigned QW-4 process. The study identified 31 tasks that are needed to implement the redesigned process.

The IRS has taken some steps to implement the recommendations of these studies. However, the IRS has not had the resources to complete all of the actions recommended in the studies.

⁷ The taxpayer is notified of this action at the same time.

⁸ Questionable Form W-4 Program Compliance Impact Report, (P/R/F:411-64-40, October 1998).

⁹ *IRS' Questionable W-4 Program: A Process Redesign Study* (Michigan Office of Research and Analysis, December 2000).

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The Program has no method to determine if employers are complying with its directives to change taxpayers' withholding amounts

Although the mission of the QW-4 Program is to promote compliance, the Program has not established procedures to determine if employers are complying with its directives to change the withholding amounts. They have not done this because IRS Program management believes there is a 90 percent compliance rate among employers; however, management did not have any data to substantiate this opinion. In addition, they have concerns that any added procedures might place additional burdens on employers.

Without a means to determine if the Form W-4 is revised and the proper amount withheld, the IRS has no means to determine the impact of the QW-4 Program on taxpayers' compliance. If the withholding is not appropriate, taxpayers might not file or might owe money when they file. The IRS has determined that balance due returns are less likely than fully pre-paid returns to be filed timely, if filed at all. In addition, the January 2002 W&I Trends, Issues, and Problems report states that about 17 percent of balance due returns are not paid when the return is filed.

QW-4 Program management information reports do not present available information in a way that is useful in identifying the most productive cases

Currently, management information reports focus mainly on identifying the number of cases loaded to the Questionable W-4 Case Control (QW-4) system and closed during the initial screening process or with lock-in letters. The reports were not designed to identify the categories of the cases worked or closed.

For example, IRS management uses two reports to determine the productivity of the QW-4 Program, the caseload report and the case disposition report. The caseload report shows the volume of cases loaded to the QW-4 system. The disposition report shows the number of cases closed and how the cases were closed (i.e., lock-in letter, no change, etc.).

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- The FY 2001 caseload report shows that 63,826 cases, approximately 10 percent of the total inventory of cases received, were loaded to the FCC, and the FY 2001 case disposition summary report shows that tax examiners closed 60,226 cases.
- The FY 2001 case disposition report shows that 41,892 (70 percent) of the 60,226 cases closed by tax examiners were accepted with no changes to the number of withholding allowances and 14,112 (23 percent) were issued lock-in letters.

However, neither report shows the categories assigned to the closed cases.

A third report, the case code closure summary report, is also available to management but it is not used to measure productivity. This report provides the monthly volume of closed cases by category, but it does not show how the cases were closed (i.e., lock-in letter, no change, etc.).

Merging data from the case disposition report and the case code closure summary report would provide management with a QW-4 Program overview of the number of cases by category that were closed by quick screening, adjusted by the QW-4 unit, or assessed a civil penalty. Management could use the report to identify which categories of cases are most productive, i.e., cases where tax examiners determined the withholding allowances or exemption claimed were incorrect. Having this additional information would allow management to select those cases in specific categories that would have the greatest chance of making a positive impact on taxpayer compliance with the tax withholding system.

Though management could not identify which categories of cases were closed during the initial screening, they have determined that some of the initial case review actions taken by the tax examiners can be automated. In August 2001, QW-4 management completed an in-depth study of the QW-4 Program in partnership with the Small Business/Self-Employed Division, Criminal Investigation, Chief Counsel, the Michigan DORA¹⁰ Process Redesign Study

¹⁰ District Area Office Research and Analysis.

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team, and others. As a result of the task force, several recommendations were made. One of the recommendations was for management to automate some of the processes performed during the initial screening of the QW-4 cases.

On March 19, 2002, the Director, W&I Filing and Payment Compliance, submitted a formal request for a programming change to automate the initial screening process of QW-4 cases. The MCC will identify cases meeting historically nonproductive criteria and place them into a designated category, eliminating manual screening. Some of the research that tax examiners completed in the past will be accomplished through computer analysis.

By automating the initial screening procedures, the QW-4 Program should be able to use more of its limited resources to work the more productive cases. The QW-4 Program change planned for implementation by October 2002 will limit the number of cases reviewed by tax examiners that require no change to the number of withholding allowances claimed. Since the IRS is already taking action, we are not making any recommendations on the initial screening process at this time.

Recommendations

The Commissioner, W&I Division, should:

1. Develop measures to identify the impact of the QW-4 Program on taxpayer compliance with the tax and withholding system.

Management's Response: The FCC will work with W&I Headquarters to develop a report that tracks the percentage of accounts that result in a lock-in letter. In addition, the FCC will keep the lock-in cases on the system for up to 10 years.

2. Develop a method to determine if the employers complied with the lock-in letters and withheld the appropriate amount from the employees' wages.

Management's Response: The FCC is developing a follow-up system that will allow them to determine if employers have complied with the lock-in letters they issue.

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The FCC is asking the DCC to maintain lock-in cases for 10 years and to generate a listing if a case has been on the system for 30 months. The information will help the FCC to monitor cases that have lock-in letters to determine if employers are honoring withholding requirements.

3. Revise management information reports to identify which categories of questionable Forms W-4 cases are productive and impact compliance.

Management's Response: FCC management has identified the categories of questionable Form W-4 cases that will be productive by using criteria to download only those accounts that have not been filed or paid. The FCC will include those categories in the screening process changes that they will add to the Request for Information Services submitted on March 19, 2002. Following the changes, FCC management will work with the DCC to revise the management reports to allow them to track the percentage of lock-in letters in each category.

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Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to determine whether the Internal Revenue Service's (IRS) Questionable Form W-4 (QW-4) Program productively identifies instances of taxpayers inappropriately claiming either excessive withholding allowances or exemption from withholding on their Employee's Withholding Allowance Certificate, Form W-4. We performed the following tests:

- I. Determined whether adequate managerial oversight and monitoring of the questionable Form W-4 case selection process exist to ensure that the most productive cases are identified for review.
 - A. Interviewed the Director, Filing and Payment Compliance, and reviewed Program guidelines to determine the overall goals and objectives of both the QW-4 Program and the questionable Form W-4 case selection process.
 - B. Interviewed managers and employees in the QW-4 Program, the Detroit Computing Center, and the Martinsburg Computing Center to understand the case selection process.
 - C. Evaluated the basis and purpose of the questionable Form W-4 case selection criteria.
 - D. Determined what reports are available for managerial oversight and monitoring of the QW-4 Program case selection process and how the reports are used in selecting cases for review.
- II. Determined whether the current questionable Form W-4 case selection process identifies the most productive cases for review.
 - A. Reviewed the Fiscal Year (FY) 2001 load reports identified in Step I.D. to determine the volume of cases available for the QW-4 Program employees to work.
 - B. Reviewed the FY 2001 case disposition report identified in Step I.D. to determine the volume of cases with no changes to the exemptions claimed and the volume of cases with adjustments to the exemptions claimed.
 - C. Reviewed the FY 2001 case closure report to determine whether information available on the report could be used by management to identify productive cases.

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Appendix II

Major Contributors to This Report

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Anthony W. Anneski, Acting Audit Manager

Paula W. Johnson, Audit Manager

Alan Lund, Senior Auditor

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Gwendolyn M. Green, Auditor

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Appendix III

Report Distribution List

Commissioner N:C
Deputy Commissioner N:DC
Commissioner, Wage and Investment Division W
Director, Strategy and Finance W:S
Director, Compliance W:CP
Director, Filing and Payment Compliance W:CP:FPC
Chief Counsel CC
National Taxpayer Advocate TA
Director, Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis N:ADC:R:O
Office of Management Controls N:CFO:F:M
Audit Liaison:
 Program/Process Assistant Coordinator, Wage and Investment Division H:WR

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Appendix IV

Processing the Questionable Forms W-4

The Internal Revenue Service (IRS) defines as questionable any Employee's Withholding Allowance Certificate (Form W-4) where the taxpayer is claiming more than 10 withholding allowances or any Form W-4 where the taxpayer's wages are over \$200 per week and the taxpayer is claiming exemption¹ from withholding.

The processing of the questionable Form W-4 begins at the IRS' 10 campuses² and is then transmitted to the IRS' computers at the Detroit Computing Center (DCC) and Martinsburg Computing Center (MCC) for further processing. The MCC assigns each questionable Form W-4 (case) to 1 of 30 category codes based on the taxpayer's historical tax account data as well as whether the employee claimed exemption from withholding or claimed more than 10 withholding allowances.

This information is transmitted to the DCC and loaded to the Questionable W-4 Case Control System (QW-4 system). Cases in 13 of the 30 categories are then loaded to the Fresno Computing Center (FCC) open inventory for tax examiners to work. The remaining cases are archived at the DCC and are not worked by the tax examiners.

Tax examiners initially screen questionable Form W-4 cases by researching the QW-4 system and the IRS' main computer system for filing history. The tax examiners try to determine if the withholding allowances claimed by the taxpayers on Forms W-4 appear appropriate. When additional information is needed from the taxpayers, the tax examiners issue Letter 2773, Initial Contact Letter. Letter 2773 asks the taxpayer to substantiate the withholding allowance claimed.

The IRS reports that most cases are closed at this point with no change to the amount of withholding allowances claimed. This happens if it appears that the withholding is appropriate based on the taxpayer's filing history or if the taxpayer is able to provide supporting documentation.

If the tax examiners determine the withholding allowances claimed are incorrect or the taxpayers do not respond to IRS contact attempts, the tax examiners mail the taxpayers' employers Letter 2800, Lock-In (Employer).³ Letter 2800 directs the employers to disregard the taxpayers' Forms W-4 as filed and to instead withhold at the rate for a single person with zero allowances or at some other rate determined by the tax examiners. The cases are closed after the letter is issued.

¹ Employees can claim exemption from withholding if they had a right to a refund of all federal income tax withheld for the prior year and expect a refund of all federal income tax withheld in the current year.

² The 10 IRS campuses are also known as service centers.

³ The taxpayer is notified of this action at the same time.

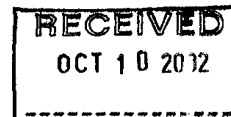
**Improvements to the Questionable Form W-4 Program Are Needed
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Appendix V

Management's Response to the Draft Report

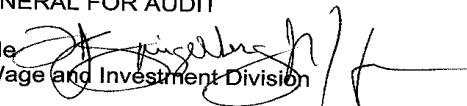


DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308



October 10, 2002

MEMORANDUM FOR INSPECTOR GENERAL FOR AUDIT

FROM: John M. Dalrymple 
Commissioner, Wage and Investment Division

SUBJECT: Draft Audit Report: Improvements to the Questionable W-4
Program Are Needed to Determine Program Impact on
Taxpayer Compliance (Audit #200240013)

Your report accurately identifies the need for changes in the Questionable W-4 (QW-4) process. A questionable Form W-4 is any Form W-4 which claims 10 or more withholding allowances, or any Form W-4 claiming exemption from withholding where the employee's wages are over \$200 per week. Employers who receive questionable Forms W-4 from employees are required to submit these forms to the IRS. We attempt to contact the employee to verify withholding allowances. If it is determined the withholding allowance claim is invalid, Letter 2800 is issued to the employer. Letter 2800, also known as a "lock-in letter," directs the employer to disregard the employee's Form W-4 as filed, and to instead withhold at the rate for a single person with zero allowances (single-zero), or at some other rate determined based on research. Without changes to the process we cannot determine if employers comply with the lock-in letters.

Rather than focusing on developing management reporting tools, as you recommended, we are redesigning the screening process and developing new inventory sources through database matching. I believe we have taken a significant step in identifying the untapped potential that exists within the QW-4 process. Database matching with state agencies, the Automated Substitute for Return (ASFR) database, and the frivolous filer database will identify more productive accounts than our current process. In addition, a new screening process at the Martinsburg and Detroit Computing Centers designed to identify non-filers and balance due accounts will dramatically increase the percentage of lock-in letters.

Our comments on your recommendations are attached. If you have any questions or need additional information, please call Pamela G. Watson, Acting Director, Filing and Payment Compliance (W&I) at (404) 338-7758, or Ronda Hon, Field Director, Compliance Services (Fresno) at (559) 454-6020.

Attachment

Improvements to the Questionable Form W-4 Program Are Needed to Determine Program Impact on Taxpayer Compliance

Attachment

RECOMMENDATION 1

The Commissioner, W&I Division, should develop measures to identify the impact of the QW-4 Program on taxpayer compliance with the tax and withholding system.

ASSESSMENT OF CAUSE

To identify the impact of the QW-4 Program on taxpayer compliance with the tax and withholding system, we must have an automated follow-up process in place that tracks the taxpayers' filing and paying records before and after we issue lock-in letters. Our system has not had the capability of providing the information we need to follow up on affected taxpayers. Current system enhancements will allow for tracking capabilities.

CORRECTIVE ACTION

Fresno Compliance Campus will work with W&I Headquarters to develop a report that tracks the percentage of accounts that result in a lock-in letter. Previous studies have shown that lock-in letters have a significant effect on taxpayer compliance. In addition, we will keep the lock-in cases on the system for up to 10 years. This will increase our ability to identify accounts for taxpayers who repeatedly file QW-4s.

IMPLEMENTATION DATE

October 1, 2003

RESPONSIBLE OFFICIAL

Director, Compliance, W&I

CORRECTIVE ACTION MONITORING PLAN

The Director, Filing and Payment Compliance will follow up with the Fresno Compliance Campus during the monthly operational manager's conference call.

RECOMMENDATION 2

The Commissioner, W&I Division, should develop a method to determine if the employers complied with the lock-in letters and withheld the appropriate amount from the employees' wages.

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2

ASSESSMENT OF CAUSE

The QW-4 Program has not established procedures to determine if employers are complying with directives to change employees' withholding amounts. While IRS management believes a high compliance rate exists among employers, we have no data to substantiate it.

CORRECTIVE ACTION

Fresno Compliance Campus is developing a follow-up system that will allow us to determine if employers have complied with the lock-in letters we issue. Lock-in cases are dropped from the History database every 48 months. Fresno Compliance Campus is asking DCC to maintain these files for 10 years and to generate a listing if a case has been on the system for 30 months. The listing will include SSN, name, lock-in filing status and allowances, date of the lock-in, and employer information. This information will help us monitor cases that have lock-in letters to determine if employers are honoring withholding requirements.

IMPLEMENTATION DATE

December 1, 2003

RESPONSIBLE OFFICIALS

Director, Compliance, W&I

CORRECTIVE ACTION MONITORING PLAN

The Director, Filing and Payment Compliance will follow up with the Fresno Compliance Campus staff during the monthly operational manager's conference call.

RECOMMENDATION 3

The Commissioner, W&I Division, should revise management information reports to identify which categories of questionable Form W-4 cases are productive and impact compliance.

ASSESSMENT OF CAUSE

The ability to properly screen out unproductive accounts and identify productive cases is an essential part of the redesigned QW-4 process. However, we believe this effort must start earlier during the screening process.

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3

CORRECTIVE ACTION

We have identified the categories of questionable Form W-4 cases that will be productive by using criteria to download only those accounts that have not been filed or paid. We will include these categories in the screening process changes that we are adding to the Request for Information Services (RIS) submitted on March 19, 2002. Following these changes, management will work with DCC to revise the management reports to allow us to track the percentage of lock-in letters in each category.

IMPLEMENTATION DATE

October 1, 2003

RESPONSIBLE OFFICIAL

Director, Compliance, W&I

CORRECTIVE ACTION MONITORING PLAN

The QW-4 Program staff will advise the Director, Filing and Payment Compliance of any delays in the RIS implementation date.

Please call Pamela G. Watson, Acting Director, Filing and Payment Compliance (W&I) at (404) 338-7758, or Ronda Hon, Field Director, Compliance Services (Fresno) at (559) 454-6020, if you have any questions.